THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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The most recent American boom which sowed the seeds of the heaviest of all economic depressions was not characterized by a rise in the general price level. This was presumed to be a sign that we could count on "eternal prosperity." That depression nevertheless followed, and in the most severe form, leads to the conclusion that the American boom of the years 1926-29 was not different in its essentials from an ordinary and that the inflationary expansion of the economic system can scarcely have been absent from it.

—Crises and Cycles, Wilhelm Röpke, William Hodge, London, 1936

Stumbling Towards Global Recession

Rarely, if ever, has there been such a dramatic divergence in the state of world economy as today. At one extreme there is the fiery U.S. economy, with its domestic credit excesses acting as the economic locomotive for the rest of the world. At the opposite extreme is the yawning Asian depression. The magnitude and the speed with which exchange rates, asset prices and economic growth have collapsed in Asia were both unexpected and unprecedented in postwar times.

The risks posed by the Asian crisis are increasing, seriously compounding Japan's economic and financial woes. Things are not just bad in Japan. They are desperate. Japan's leadership knows it, but the Americans who lecture them, don't. Japan is definitely trapped in a vicious downward spiral, led by a relentless plunge in investment spending, for which there is no ready medicine.

Meanwhile, over the last three or four years, the sizzling U.S. economy has pulled the rest of the world behind it. Implicitly, its inherent health, strength and staying power has become a question of paramount global importance. Which extreme will, after all, gain the upper hand in the world economy? The Asian depression and deflation or the U.S. boom and asset price inflation? We have no doubt about the final outcome.

Our critical opinion about the U.S. economy remains unchanged. Yes, it has tremendous momentum, but it is the deceptive strength of an extremely unbalanced bubble economy. Its continuance is completely dependent on uninterrupted, inordinate debt growth and financial leveraging. The impossibility of this guarantees a violent ending. The one question that is now foremost in our mind is what will happen to the world economy when the U.S. economy stumbles? Europe's less-than-robust economy is definitely unable to pick up the baton. In short, a serious global recession looms on the horizon.

So far, though, any bad economic news seems to embolden investors, with stocks in America and Europe once again shattering records. Interestingly, and ironically, this euphoria comes alongside unmistakable signs that Asia's woes are far worse than expected. They are already beginning to bite the U.S. economy with an exploding U.S. trade deficit, ballooning inventories, falling industrial production, a badly faltering agricultural sector and, importantly, collapsing profits throughout the manufacturing sector.

ASIAN MAELSTROM

It is one year now since Thailand's currency melted down. At the time, no alarm bells rang outside the area. What is Thailand in the world economy, anyway? There was no inkling of the serious and complex nature

of the unfolding Asian crisis and the speed and power of the following global contagion. Nor was there any inkling of the rapidly approaching recession in Japan. Looking at the booming stock markets in Europe and America, it seems there still is unmitigated complacency.

The collective self-deception about the global implications of the unfolding Asian crisis started with a narrow focus on bilateral trade exposure to these countries, measured as a percentage of total GDP. For the U.S. economy, this was calculated as "only" 0.7 percent of 1997 GDP. For Europe it was even less, 0.6 percent, and for Japan, the hardest-hit among the industrial countries, it was still just 1.4 percent of Japan's 1977 GDP.

We have always dismissed these calculations as misleading and apt to conceal the severity of the crisis. In the first place, such trade effects should be seen not as a proportion of total GDP but in relation to current GDP growth. The 1.4 percent trade hit on Japan appears rather marginal in comparison to total GDP. However, this small percentage, which exceeds Japan's GDP growth in 1997 of 0.9 percent, is enough to push Japan's economy over the edge and its yen into a slump, compounding the woes in the region. In Europe's case, the Asia-related trade loss of 0.6 percent of GDP compares with real GDP growth last year of 2.6 percent.

The second great shortcoming of those comforting calculations is that they ignore the implicit self-reinforcing, two-way contagion process. While the Asian crisis has crucially contributed to Japan's slide into recession, Japan's recession and the associated slide of its currency, in turn, are severely hurting the rest of Asia. As was to be expected, we are seeing a second-round contagion between Asia and Russia, parts of Eastern Europe, Latin America, and South Africa. Each of these crises, in turn, is amplifying the downturn in the other countries and fueling the U.S. bubble as capital flees these troubled economies seeking a safe haven in the United States.

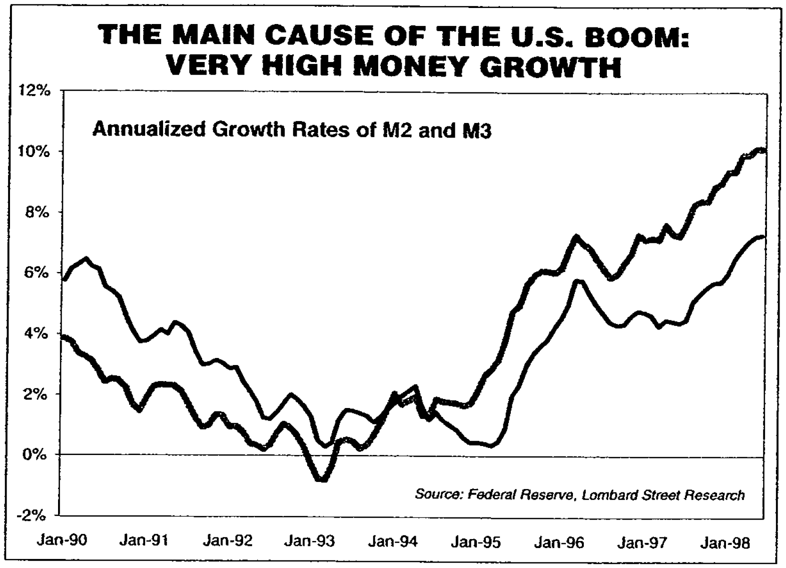
U.S. MONETARY EXPLOSION

The U.S. economy is still buoyant, but the trade gap is escalating alarmingly. U.S. net exports appear to be on track for a massive $100 billion deterioration this year, equal to over 1.3 percent of GDP. They have ground to a halt this year, following an 18 percent gain in the year ended 1997. While this slowdown has been fairly comprehensive, capital goods are the main victim. Real exports in this sector had soared by $132 billion, or 28 percent, over the year ended December 1997, but have been little more than stagnant since. By contrast, import growth continues to roll along at a near-20 percent annual rate, propelled by booming domestic demand. Most of the predicted slide of net exports for the whole of 1998 already has occurred. Further, assessing these figures, one has to bear in mind that the deterioration of the U.S. trade balance has been considerable cushioned by plunging import prices.

Yet Asia is definitely not the only culprit behind this ballooning U.S. trade deficit. An essential prerequisite has been an explosive expansion in domestic demand. But what has primarily fueled this extraordinary demand growth? The following chart, really, ought to lay to rest any talk about the U.S. economy's "new paradigm" because it reveals a very different source of this economic growth: a virtual monetary explosion. Whereas the broad M3 measure had expanded about 1 percent a year in the five years to end-1994, it has since then been surging at an average annual rate of 8 percent. Considering the low inflation rate, in real terms this is an exceptionally high rate of monetary expansion.

To put it further into perspective, this money growth rate compares with an average rate of nominal GDP growth of 5.4 percent. It provides enormous liquidity for financial assets. Such a big and protracted excess of money creation is typically both the hallmark and the cause of a developing asset price bubble.

Shocking as these money figures are, they really vastly understate the expansionary thrust imparted by the



U.S. financial system to the national economy and the asset markets. Money growth reflects but one of three potential sources of money for spending: bank lending. Bank lending creates the bank deposits that form the bulk of the money supply. In recent years, however, an ever greater part of U.S. spending has been fueled by credit provided by the securities markets and by heavy drawing on existing money balances. So, actually, for each dollar added to the money supply, two dollars were added to the debt level.

While Europe discarded the Asian crisis instantly as rather irrelevant for its own economic performance owing to the small importance of trade with the countries concerned, Wall Street pundits went one better. They claimed Asia troubles were having a positive net effect on the U.S. economy. By containing inflation, the argument went, the inherent trade drag and the sharply declining import prices had preserved the continuation of the Fed's loose monetary stance. Wall Street claimed this strong liquidity was "positive" would more than offset the trade "negative." Second, as surging safe-have inflows of foreign capital boosted the prices of stocks and bonds, they reinforced consumer wealth effects and consumer spending while lowering the cost of equity and debt capital for business investment. Third, falling import and commodity prices have spurred higher real income and consumption growth. All these "positives," it was happily concluded, would more than offset the trade "negative" of full-fledged deflation in Japan.

Last but not least, the successful, rapid solution of the Mexican crisis in 1995 seems to have encouraged the early, false optimism about the implications of the Asian crisis. Fiscal austerity and the issuance of government bonds backed by oil revenues had worked quick wonders on investors' confidence and the country's capital account. Shaken confidence was quickly restored. But no less importantly, the ensuing Mexican export drive was readily accommodated by the booming U.S. economy, accounting for 85 percent of Mexican exports. In Asia's case, the Japanese economy, which ought to be the engine of growth, is sinking into recession, aggravating the regional crisis.

Right from the beginning, we have warned that the precedent to look at for the Asian crisis is not Mexico. It is Japan, where—eight years after the bursting of the bubble—the economic situation is going from bad to desperate. In these Asian tiger economies, the bubble-related rot is virtually identical to Japan's: huge existing malinvestments in industrial capacity and property, massive wealth and liquidity destruction through the collapse of asset prices, and mountains of bad loans leaving behind a vulnerable and illiquid banking system.

ASIAN TIGERS VERSUS JAPAN—THE OMINOUS DIFFERENCE

Despite the great similarities, though, there is a crucial difference between the tigers and Japan: Japan has a big trade surplus and is the world's greatest creditor while the tigers are loaded up with foreign debt. If they start printing money, collapsing currencies would exacerbate the foreign debt burden.

Even then, though treated for years with rock-bottom interest rates and big doses of fiscal deficits, the Japanese economy has failed to respond with a sustained recovery. But Americans flatly refuse to believe in the

possibility of such an exigency. In American eyes, any policy failure essentially reflects inept policies. Japanese reluctance to act more forcefully rather reflects a different viewpoint—a general resignation that fiscal pump priming of any kind, involving ever higher public indebtedness, is more harmful than beneficial in the longer run. This sense of hopelessness is pervasive. Even the monthly reports of the Bank of Japan are lately spreading doom and gloom. Read this:

> Japan's economy remains stagnant reflecting weak domestic demand, such as household expenditures. In addition, corporate sentiment has been deteriorating across industries, indicating strong downward pressures on economic activities.
>
> With respect to final demand, growth in net exports, which had been underpinning the economy, has slowed and business fixed investment seems to have started declining. Private consumption continues to stagnate despite the implementation of special tax-cut measures. Housing investment has also continued to be weak and public sector investment is on a decreasing trend. Against the background of significant accumulation of inventories reflecting weak final demand, industrial production has continued to decline. Consequently, negative impacts on corporate profits as well as on employment and income conditions have been intensifying, and are leading to a further deterioration of domestic demand.
>
> Corporate profit projections have been revised sharply downwards at firms in all industries primarily due to the slump in domestic sales...Given these profit conditions, business fixed investment is beginning to decline after having peaked out.

A bleaker description of the economic situation in the world's second largest economy is hard to imagine. Every single GDP component of Japan's economy is currently sinking. Hit by the demand collapse in the tiger countries, even Japan's export motor has now stalled. What's worse, the rising export surplus no longer originates in rising exports but in falling imports, reflecting the shrinkage of Japanese domestic demand and declining import prices.

LOOMING YEN DISASTER?

In this light, progressive yen weakness appears a foregone conclusion. Capital outflows on account of personal and institutional investors are rapidly escalating. Assessing the future course of the yen essentially boils down to the question of whether capital flows or the current surplus will rise faster. Of the many questions that the Japanese quagmire poses, this one is the easiest to answer: capital outflows. They may yet explode, implying a very weak yen, so weak, in fact, that it may throw the region into outright financial disaster and depression. Only the re-imposition of capital controls may be able to prevent this calamity.

Two factors are relevant for the potential size of future Japanese capital outflows: interest rate expectations and ill-timed moves toward full liberalization of the Japanese capital account. There is heavy American pressure to lower interest rates and liberalize capital account. Both of these influences are sure to worsen.

Japan's interest rates are at lows, where no further reduction is conceivable. Yet the propensity of Japanese investors to chase higher yields in other currencies essentially rises or falls with changing expectations about the further duration of their own rock-bottom rates. As the economy's slide into recession shifts any possible rate hike into an indefinite future, the desire and willingness for foreign investment essentially get a strong fillip. But what promises to turn these outflows into a deluge is the coincident Big Bang in Japan which is making it easier for Japanese households to make portfolio investments abroad.

Phase I of this liberalization, effective since April 1, has already triggered a sharp rise in portfolio capital exports, greatly contributing to yen weakness since then. The second installment of BIG Bang, to be implemented on December 1, 1998, will deregulate the trust funds in Japan, which currently account for the equivalent of some $9 trillion U.S. dollars on deposit yielding less than 1 percent. These funds have been prohibited by regulations from investing outside Japan.

Given the present paltry domestic yields and the widespread despair in Japan about the dismal financial and economic prospects, it has to be assumed that in the pursuit of higher yields a large part of this huge pool of liquid funds will pour into the international financial markets. Wall Street is already looking forward to this event, assuming that the massive injection of new Japanese money into world financial markets will gravitate heavily to the United States, more precisely, to Wall Street.

One can only hope that the Japanese authorities will repeal their promise of liberalizing their capital account further. Surely, the global securities markets are not in urgent need of still more excess liquidity from Japan. But the world economy does need a more stable yen. The yen's ability to sink much further, should not be underestimated. Above all, for Japan to export its way out of this mess, other countries would have to accommodate its export boom initiated by a further steep devaluation of the yen. Who would? the United States? Europe? The surest thing to expect from a falling yen is a devastating impact on the whole Asian region by sending currencies and stock markets into another tailspin, dramatically worsening the financial crisis.

NO CURE AT ALL?

With regards to Japan's recovery, we can only elaborate on our remarks in the last letter. It's a vain hope. Despite the government' massive deficit spending and near-zero interest rates in the past years, the situation has been going from bad to worse to desperate. With their obsessive insistence on the implementation of an explicit permanent tax cut as a kind of magic cure, the Americans reveal both a gross misconception of what has been spurring their own economy and even less understanding of the opaque combination of economic and financial maladjustments at the core of Japan's crisis.

The whole of Far Eastern Asia suffers from an "ailment" completely unknown to America, which is definitely not curable by a tax cut, however permanent. This "ailment" is a supply of current domestic savings vastly in excess of domestic credit demand, making these economies excessively dependent on export growth.

The thing to see in the first place is that Japan, together with the United States, has already the lowest tax take among industrial countries, accounting for 32 percent of GDP, as against 45 percent in Euroland. Principally, a tax cut shifts income and cash from the public sector to the private sector, the hope being that the beneficiaries will spend most of the money.

DRASTIC CORPORATE CONTRACTION

What private households and businesses in Japan lack is by no means spending power but a willingness to spend their liquidity, even though it yields almost nothing. Japanese consumers have accumulated savings of approximately $10 trillion, or on average $80,000 per person. Even if taxes were cut by $280 billion, as widely expected, this would generate $400-500 in tax savings per head. Individually, that's peanuts. Consumers, deeply worried about their future, would most probably put this bit of money straight into their savings account.

It is not the consumer, but the business sector that is at the center of Japan's former bubble and present virulent aftermath. Vastly excessive capacity expansion in the industrial sector and in commercial property is

essentially followed by a prolonged, painful period of economic and financial readjustment. There is no better illustration of the kind and extent of the monstrous imbalance that resulted in the course of events than the next chart. Its key feature is marked by the thick black line, showing the sequence of rampant investment excess, promoting heavy overexpansion of capacity, and the ensuing investment plunge.

Until the first half of the 1980s, the corporate sector had an average financial gap - that is, an excess of expenditures over revenues—amounting to 2.9 percent of GDP. During the bubble years 1987-90, this gap peaked in 1990 at a staggering rate of 9.1 percent of GDP. With the bursting of the bubble, corporate investment spending plummeted.

In 1994, the corporate sector recorded a financial surplus for the first time ever, spending less than its cash flow. Ever since, corporate expenditures have progressively fallen below current revenues, running 1996 a financial surplus equivalent to 6.6 percent of GDP. In lockstep, corporate borrowing has collapsed. In other words, the business sector, formerly Japan's growth motor, has shifted from massive demand expansion to massive demand compression. This comes on top of the substantial demand compression exerted by the high-

Profits in Crisis:

An update on our recommendations

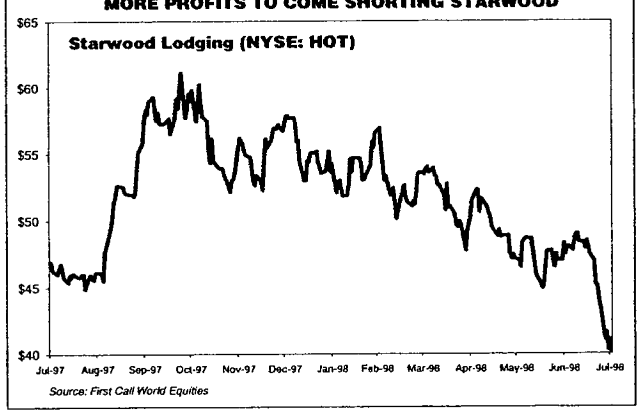
Our recommendations have been serving us well.

In May, we recommended shorting shares of Starwood Lodging. Since our recommendation, the shares have fallen nearly 20 percent. Back then, we stated: "Once the shares break down below $44, there are no fundamental or technical stopping points – look out below!" The shares have now broken down, and we still recommend shorting the stock.

Starwood Chairman Barry Sternlicht now realizes that he's in trouble. As we predicted, the government is coming after him for his unfair corporate structure. Sternlicht is still trying to dodge the bullets—as we go to press, Sternlicht has promised to unveil a new corporate structure soon after the legislation is passed. But he can't run from the Feds forever, and when Starwood is forced to play fair, it will struggle along with the rest of the hotel industry, which is suffering from oversupply. Stay short Starwood while the bottom falls out, and set a trailing stop at $48.50.

In June, we recommended long-dated German government zeros. At the time, the yield on ten-year government bonds was 4.9 percent. As we predicted, interest rates have fallen to 4.6 percent as the real yield has narrowed. This has been great for holders of German zeros. The D-mark is unchanged from the time of recommendation at 1.78, so there has been no gain or loss on the currency. With inflation now under 1 percent in Germany, the German zeros are still attractive.

MORE PROFITS TO COME SHORTING STARWOOD



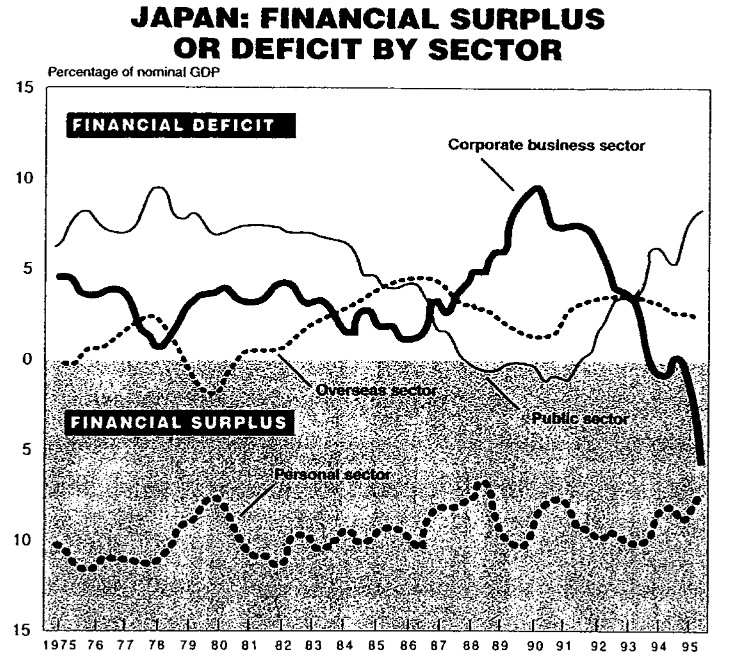
Source: First Call World Equities

In July, we recommended U.S. government zero coupon bonds. With our call for deflation, interest rates have fallen to 5.5 percent, and our anticipated fall in the yield on 10-year bonds will pay off handsomely to holders of zeros. If you don't want to take the interest rate risk, the yield curve is flat from one to ten years, so just shorten your maturity.

Our buy recommendations on German and U.S. government bonds are still in place. And one final note, if you are still short Compaq, close it out now, as the stock price is clearly going against the fundamentals. *S.S.*

saving private households. In combination, the two sectors had in 1996 a financial surplus equivalent to 12 percent of GDP.

Over the past years, this growing compression of private sector demand has been partly offset by strong rises in government deficits and exports. But these two demand components are now stagnating, while the plunge in corporate spending continues.



Source: Bank of Japan, Quarterly Bulletin, November 1997

Policymakers and the public in Japan are convinced that a tax cut, however permanent, will cure nothing. Not only would it further worsen the public finances, but given the public's awareness that the government would only make this cut as a surrender to American pressure against its own persuasion, it might well backfire by undermining public confidence.

To arrive at sustained economic growth, Japan essentially needs a continuous injection of new spending power. For that, however, there exists but one single domestic source—a continuous credit expansion. What Japan crucially lacks is substantially more debt creation by the private sector to finance more investment or consumption. The Americans are right in pressing for banking reform. But as we explained before, the fragile banking system is probably not the only factor inhibiting Japan's vitality. So is very weak credit demand.

Policy makers in Japan, actually, face two formidable challenges. The one is the need for massive stock adjustment, that is the need to absorb the huge malinvestments which have accumulated during the four bubble years. The other one is the need for a correspondingly massive balance sheet adjustment among banks, from the glut of bad loans, and among corporations, from their malinvestments and the collapse of asset prices, which have ravaged their liquidity and wealth. They all have to rebuild their capital base and their liquidity.

VICIOUS SELF-DEFLATION

And how is that rebuilding to be done? In short, normally it is accomplished by curtailing expenditures below current revenue and income. That is just that is what the noted rising financial surplus of Japanese corporations reflects is happening. But unfortunately, if this medication is applied collectively, it has the opposite effect of setting the vicious fallacy of composition in motion. As revenues are mutually curtailed, the supposed cure turns into vicious self-deflation of profits and investments.

Japan's crisis, in short, is structural, not cyclical. Given a drastically deteriorating economy, the demand for liquidity is skyrocketing, while demand for credit has collapsed. After the breakdown of strong economic growth in the wake of the bursting of the bubble, Japan's weakened economy is simply no longer able to deliver the high level of investment spending that is required to absorb the prodigious supply of domestic savings. Alternative solutions, in theory, are a switch to export-led or consumer led-growth. But the first is neither desirable nor feasible under present global economic conditions. The second choice, turning Asian consumers into American-type rampant borrowers and spenders may be desirable but is not conceivable for many years to come.

pulling off some artificial "positive earnings surprises" to cheer the market. This same trick has now been played for three quarters, effectively sustaining the illusion of permanent positive profit "surprises," while average S&P per share earnings are actually a little below their level a year ago. Investors don't object to any deception as long as it tends to boost stock upward.

As a consequence, the whole of the rise in share prices has for more than a year been coming from soaring valuations. For the S&P 500, the P/E ratio is up year-over-year from 22.75 to 30.01 and for the S&P Industrials Index from 25.20 to 33.09, with the dividend yield down to a record low of 1.23 percent. If one could adjust for the unusually great accounting abuses by which earnings are widely jacked up, these ratios would be even higher. But undeterred, analysts predict S&P earnings will be up a wild +20 percent y/y in 1999's first quarter. At best, there will be a further stagnation in profits. A sharp decline appears more probable.

OUT OF CONTROL

With global growth in jeopardy, it is not surprising that the U.S. Administration is now acting aggressively. Secretary of Treasury Rubin's recent incursion to support the yen incited a powerful rally with investors only further inspired by the hasty Russian bailout. Leading the bull charge, the technology heavy NASDAQ 100 (NDX) index and the securities brokerage stocks surged nearly 20% in just one month. The NDX, now trading with a price-to-earnings ratio of almost 60, has year-to-date gains of nearly 50%, while the brokerage stocks have advanced more than 80% the past 12 months. Indicative of sentiment, this rally has seen spectacular speculative runs in the internet sector while industrial stocks, even bluechip bellwethers like of Caterpillar, Deere, Alcoa, International Paper and Motorola, go nowhere. Indeed, the Morgan Stanley Cyclical index has only a slight gain for the past twelve months.

One thing is clear, Wall Street, the banking industry and, really, the entire mammoth U.S. financial infrastructure is moving full speed ahead regardless of either global developments or alarming deterioration in the farming and manufacturing sector. Financial data from the first-half of the year are stunning. With issuance now surpassing $5 billion a day, Wall Street underwrote almost $1 trillion of new securities during the first six months, fully 40% up on the heady levels of last year. According to Securities Data Corp., straight debt issuance surged almost 70% above 1997's first-half and stock offerings 45%. A literal junk bond bonanza saw almost $100 billion of issuance, 70% greater than the same period last year. In addition, the unprecedented mergers and acquisition melee proceeds unabated with the sum of $973 billion in announced deals for the first half, already surpassing last year's record for the whole year.

The issuance of mortgage-backed and asset-backed securities surged more than 70% to $278 billion bolstering the continuing residential housing boom. Fannie Mae, who, by the way, expanded its balance sheet by an additional $26 billion during the second quarter, recently revised its projection for total 1998 mortgage-backed securities to a record $1.2 trillion in new issues, 20% higher than 1997. Outstanding credit card debt, growing at double-digit rates, now approaches $450 billion as credit card limits reached a mind-boggling $1.78 trillion. While data are not yet available, syndicated bank lending appears to be running considerably above last year's blistering pace. In 1997, total syndicated loan originations surpassed $1 trillion (of which $190 billion was in sub-investment grade leveraged loans, an increase of almost 50% from 1996).

It is always the runaway debt creation and the associated egregious malinvestments generated by the asset price bubble that severely and hopelessly impair both a financial system and economy for years to come. In Japan as well as in southeast Asia, the bubble-induced credit excesses predominantly manifested in the real economies in malinvestments and overinvestment in technology-related and export oriented industries and

commercial real estate. We suspect that current U.S. bubble is even more prodigious. It is now growing almost exponentially. But in contrast to Asia, the rampant credit excess are mainly fueling overconsumption and malinvestments in the telecommunications and media industries. Export industries are certainly not in favor.

Wall Street is leading a massive borrowing and spending boom throughout the telecommunications and media sectors. According to American Banker, a staggering $140 billion of new securities and lending was directed to "Media/Telecom" by the "top players" alone during 1997. The top 20 investment banks provided equity underwriting of $10 billion, $81 billion of syndicated loans, $24 billion of "leveraged lending," and $25 billion in junk bonds. All indications are this year's borrowings are substantially in excess of last year's alarming sums. Literally, an ocean of money is driving prices of radio and television stations, billboards, production companies, professional sports franchises, internet businesses and cable networks to the stratosphere. Bidding wars lead to ever-more ridiculous valuations of earnings and underlying cash flow. For example, look at Clear Channel Communications, the largest operator of radio stations in the United States. The stock now trades at nearly 16 times revenues, 66 times cash flow and 180 times earnings. Wall Street and the banking industry all scramble to get a piece of the action.

With today's unrestrained communications arms race, there is truly unlimited credit demand—and unlimited credit supply—to build infrastructure for the so called "information superhighway". Be it competing systems offering local or long distance telephone service to home and business; fiber optic lines for carrying digitized data cross town or across the Atlantic; cellular phones, PCs, paging and microwave systems for wireless communications; or extensive satellite networks for voice and data transfer; borrowing and spending booms throughout the entire industry.

Nothing, however, has aroused animal spirits like the Internet. Seemingly infinite credit and capital is available for anything related to the Internet, be it companies providing internet access, content, services, electronic commerce or any remotely related technology. No one, however, questions whether this massive spending boom is a sound investment and a healthy allocation of resources. Is it really necessary for every home and office to have internet access through three mediums; telephony, wireless and cable technologies? We argue strongly that this is not much more than Wall Street and bubble economy inspired malinvestment and, similar to Asia, will be painfully recognized as such with the inevitable bursting of the bubble. Unfortunately, at that point there will be little we can do to mitigate the damage done during the boom.

Nonetheless, a crowd of companies, many formed during the past two years, aggressively raises tens of billions for building physical infrastructure. Access to money could not be easier in spite of the fact that many of these fledgling companies have yet to develop core businesses. According to Bloomberg Magazine, junk bond telecommunications debt has grown from 1% of the market at the end of 1992 to 17% as of April of this year and dollar volume of new issuance has more than tripled since the first quarter of 1997.

With traditional measurements of value and creditworthiness non-existent or useless for such non-traditional early-stage financings, it has become nothing more than "concept" speculating. Regardless, today's ebullient investors have a seemingly insatiable appetite for both the "concept" and the hefty yields offered by this junk debt. Many of these securities do not even carry ratings. Companies now are able to borrow aggressively many months and even years before they expect to have any revenues. And profits? Well, actual profits on such investments is but a dream. Many of these borrowers exclude the payment of interest for years to come. Many other companies simply issue zero-coupon junk bonds. It makes the junk-bond and leveraged buyout craze of the late 1980's look like child's play! In fact, it is exactly this type of "investment" at the height of a bubble that so impairs the long-term health of both the financial system and economy. Today Alan

Greenspan and the bulls trumpet the "healthiest" economy in decades. We see a financial system completely out of control and an economy inexorably on the path of self-destruction.

CONCLUSIONS:

Booming stock markets obscure the fact that the global economic outlook is the worst it has been in the whole postwar period. Powerful deflationary forces are unfolding, as the economic Asian contraction is hitting a world economy that is flagrantly out of balance. There is no sign of bottom for the Asian downturn. Meanwhile world manufacturing is caught in a ferocious squeeze emanating from the trade with Asia, hitting both volume and prices.

There is a growing risk of contagion elsewhere in the emerging economies through the steep decline of commodity prices and retrenching international lenders and investors. Recovery of these countries depends crucially on export-led growth which essentially has to be accommodated by the economies of the United States and Europe. Will they, can they deliver?

Eurloland is definitely not riding to the rescue. Though domestic demand has strengthened, the region remains for its further growth nevertheless heavily dependent on running a huge export surplus. Manifestly, the world economy has become hostage to the profligate spending habits of the American consumer. Without it, the global situation will dramatically worsen, jeopardizing also Europe's recovery. That's our expectation.

U.S. manufacturing is already badly hammered by the soaring trade deficit. But Wall Street is betting that an exuberant consumer backed by easy credit and further opulent wealth effects from the booming stock markets, will continue to overpower these trade woes, keeping strong overall growth on track, resp. that manufacturing weakness will be offset by service sector strength.

It's a preposterous idea. First and foremost, it would further unbalance the U.S. economy towards unsustainable overconsumption. As well, it completely ignores the implicitly growing downward pressure in the trade sector on corporate profits and from there further on the stock market, capital spending, and employment, hitting the consumer.

Given this global growth backdrop, the global inflation performance should continue to surprise on the low side. The next move in U.S. interest rates, albeit much later this year, will be down. Essentially, this development will be conducive, also later this year, to a falling dollar.

Don't let yourself be deceived by the low inflation rates. The world economy is out of balance as never before, except for the late 1920s. The risk of a more traumatic scenario involving the whole developing world in a global debt crisis is increasing.

THE RICHEBÄCHER LETTER

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